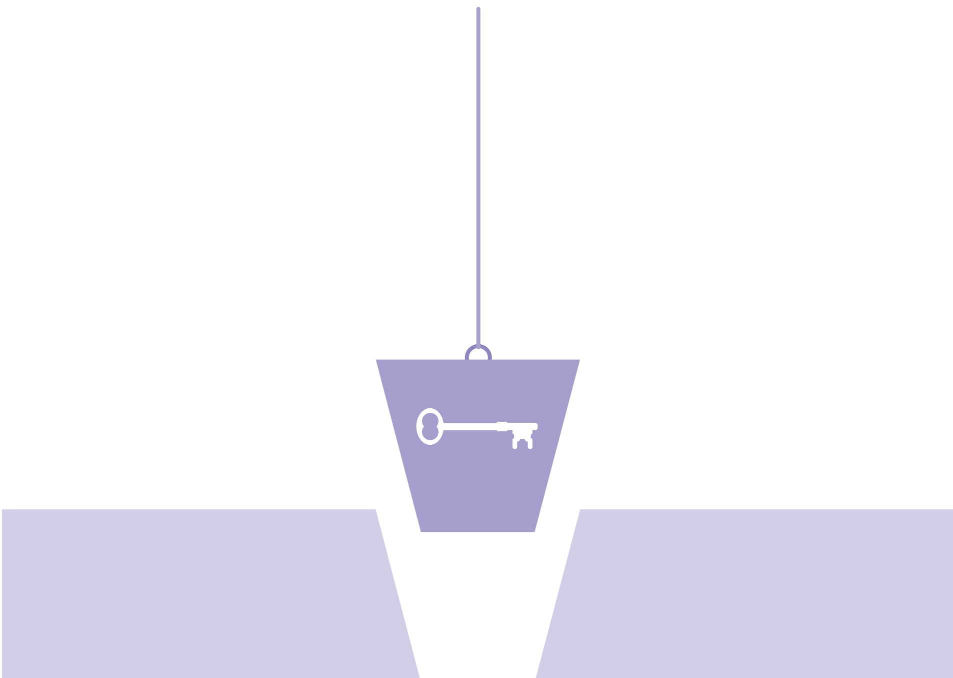
Tomorrow's Corporate Governance:

Bridging the UK engagement gap through Swedish-style nomination committees



tomorrow's company

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Foreword

The financial crisis has once more reminded us that we need effective challenge in the boardroom. This in turn depends upon the joint exercise of stewardship by boards and major shareholders.

In the aftermath of two major policy reviews in the UK, there is now widespread acceptance that there has been a failure of stewardship and a search has commenced for practical solutions to bridge the engagement gap.

The difficulty now lies in identifying tangible measures that will have a direct impact, particularly in an economy such as the UK where the shareholdings have become very dispersed. How can shareholders be persuaded or forced to hold company directors to account? In the UK and the US nobody pretends that the annual general meeting of shareholders achieves this. The recent debate about stewardship and "ownerless corporations" has arisen because it is widely felt that the other mechanisms for dialogue between companies and their shareholders have not achieved it either.

Corporate leaders need the freedom to lead, but they also need to hear contrary voices and be accountable for their performance and behaviours that underpin that performance. That accountability is a central aspect of engagement by the owners in most private, family or employee-owned businesses. How do we replicate it in the dispersed shareholding model?

The idea for this study emerged from a series of conversations in 2008 and early 2009 between Tomorrow's Company and Cevian Capital. The conversations followed the publication by Tomorrow's Company of its 2008 *Tomorrow's Owners* report which drew attention to the importance and neglect of stewardship by major shareholders. Cevian, one of Europe's most experienced activist investors, shared its 'war stories' of active ownership and engagement with company boards management teams and fellow shareholders in several of Europe's major markets. As a business-led think-tank with an agenda-setting track record in corporate governance, Tomorrow's Company was especially fascinated by Cevian's description of the governance climate in Sweden, Cevian's original home market.

In an intriguing twist, it emerged that it was the work of Sir Adrian Cadbury and his 1992 report on governance which first stimulated the evolution of Sweden's shareholder-led nomination committee system. It seemed to Tomorrow's Company that there might be lessons and solutions relevant to the UK and other markets where shareholdings are widely dispersed. While the Swedish system is, of course, different from the UK system, we believe that the examples and experiences described in this brief study may help investors, policymakers and boards in their search for those solutions. This project will have achieved its purpose if its recommendations accelerate the process of fresh thinking and experimentation in the UK and elsewhere.

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Executive summary

Directors serve as the agents of a company's shareholders. Their duty is to promote the best interests of the company. It is the shareholders who elect the directors for the system to work properly in the long-term. In the interests of those shareholders, it is essential that they find and elect the right people to serve on the board.

In the UK there is a lack of commitment on both sides to the investor-company relationship and there are weak incentives for engagement. Many of the larger shareholders in Sweden believe engagement with companies promotes long-term value creation. In Sweden there is a stronger tradition of commitment by major shareholders This study looks at developments in Sweden over the last 15 years which have strengthened engagement from which valuable lessons can be learned. At the heart of these developments is the proliferation of shareholder-led nomination committees and the impact that has had on company boards.

There are differences in composition between Swedish and UK boards. The UK unitary board brings together executives and non-executives. In Sweden the board is primarily made up of non-executives, and the CEO is sometimes but not always a member. This may make a Swedish board look similar to a supervisory board in Germany. However, as in the UK, a Swedish board has the operational responsibilities of a unitary board. In Sweden, as in the UK, directors owe their duty to the company, and are accountable to shareholders.

In both systems nomination committees (NCs) are the body with responsibility for finding the right people to serve on boards.

In the UK the NC is a sub-committee of the board. It is made up of board members. It is usually chaired by the chair of the board. Board candidates are proposed by the board's NC to the company's Annual General Meeting and, in the vast majority of cases, are elected as a matter of course.

In Sweden, the NC is not made up of board members, but is usually composed of four or five of the largest owners of shares in the company, together with the non-executive chair of the board. It has its mandate from the shareholder's meeting. In addition to recommending to the shareholders at the Annual General Meeting who should join the board, it also recommends the structure and amount of remuneration for each director. The shareholders then make the decisions. The remuneration of executive management is handled separately by the board.

This report looks at what the UK can learn from the Swedish system and whether a similar approach would work in the UK.

This is timely given the reviews of corporate governance which have taken place in the UK in the course of 2008 and 2009. The search is on for stronger shareholder engagement and for a more diverse and challenging boardroom.

Our findings

The Swedish pattern of ownership is different from that in the UK or USA, but in recent years those differences have diminished. The caricature is that ownership is dominated by four or five controlling family shareholders. However, today these owners are only part of the picture. Local pension funds, mutual funds, international investors and others play their part alongside investment and family groups. The rate of turnover of share holdings in Sweden has also increased significantly in the last twenty years and is much closer to that experienced in London or New York.

Attitudes to ownership are different in Sweden. The shareholders' meeting stands at the peak of a governance hierarchy and can, if necessary, issue instructions to the board. Boards are subordinate to the AGM and the company's executive management is subordinate to the board. Only one executive can sit on the board. Swedish shareholders traditionally have a more prominent and proactive role and this is particularly reflected in the way the nominations process has developed. In the UK the NC is a sub-committee of the board. In Sweden it is a servant of the AGM.

NCs have evolved over 15 years, although they have only been a formal requirement since 2005. They were originally a Swedish application of the recommendations for the UK in the 1992 report by Sir Adrian Cadbury.

The experience from Sweden is that:

- active shareholder engagement in the nomination process has increased confidence in the board function and increased the expectation that the board members will look to further the interests of the company and the shareholders;
- what started as a publicly-declared opportunity for shareholders to participate in the NC process has come to be seen as a responsibility to do so. This has stimulated shareholders to become more engaged and provided a public opportunity to demonstrate that they are being good stewards of their investments; and
- the NC process has brought shareholders together, in a forum that prompts them to think harder about pursuing the interests of all shareholders and to collaborate to this end.

But the system is not without difficulties.

The skills and priorities needed to be a good NC member are different from those of being a good fund manager or governance expert.

Some shareholders, especially international ones, decline to take up a place. Some worry about the possibility of being made an insider through their participation. Shareholder participation does not eliminate differences of view between shareholders and these differences can come out in the NC.

The Swedish system is still evolving as those involved deal with the difficulties.

Would shareholder representation on nomination committees work in the UK?

Nomination committees that are more directly representative of shareholders could play a part in the improvement of the quality of governance and stewardship in the UK.

The key to the success of the NC process in Sweden is the willingness of institutional shareholders to participate, and the development over time of suitably qualified and experienced people to represent shareholders on nomination committees. The key benefit of this participation is being able to influence board composition in a thoughtful way and so improve the accountability of the directors to the shareholders. The arrangement gives directors a renewed mandate each year from shareholders whose participation becomes proactive rather than reactive.

In principle, there is nothing under the current 'comply or explain' arrangements of the UK's corporate governance code to stop a company listed in the UK from implementing the arrangements which operate in Sweden.

In practice, just as the Swedish system evolved in stages, it might therefore make sense for UK companies to experiment – first by inviting major shareholders to nominate representatives to serve on their existing nomination committees.

The nomination committee is an obvious starting point for experimentation but it is not the only one. Some companies may choose other channels for shareholder participation. The SEC has proposed changes to the conduct of board elections to permit shareholder proxy access in the United States and the 'voto di lista' arrangements in Italy provide another option.

The most important learning for the UK from the Swedish experience is that if stewardship is to take a leap forward, it needs to be part of some formal process in which major shareholders engage with companies and start to work together in a more proactive way than is experienced at present.

The choice is not between a shareholder-led nomination committee and no change. It is between this solution and other stewardship solutions. Those who oppose innovation in this area need to come up with their own ideas for making stewardship real.

Agenda for action for the UK

For listed companies

1. **To take the initiative to include shareholders on the board nomination committee, possibly to the point of forming a shareholder-led nomination committee, on which the Chairman and perhaps the Senior Independent Director (SID) would sit**. The benefit of this change is that it would create a systematic involvement for major shareholders in the process of nominating board members.

For institutional investors

2. **Fund managers to recruit, train and support suitably qualified people to sit on nomination committees as their representatives.** This cadre may be drawn not only from current fund managers and governance specialists, but also from former chairmen or directors of listed companies, those with experience of board membership of listed or private companies and others with relevant experience from for example the accounting, legal and investment banking professions.
3. **Over time, a body such as the Institutional Shareholders Committee to facilitate and promote the use of nomination committees as a beneficial innovation in terms of encouraging stewardship.** The benefit of this intervention would be to overcome some of the resourcing obstacles which discourage such engagement at present. Initiatives could include:
    - taking a lead in promoting experiments, using common criteria for evaluation and stimulating the exchange of good practice; and
    - promoting co-ordination between major institutions to encourage burden-sharing, involving major international investors including sovereign wealth funds.

For pension funds

4. **Re-examine their contracts with index and other fund managers. As clients they have the opportunity to specify the level of active engagement by these funds in the nomination process.** The benefit of this recommendation, especially if applied collectively, is that it would create momentum for and innovation in stewardship by making engagement by index and other fund managers a client requirement.
5. **Pool their efforts through National Association of Pension Funds (NAPF) or other bodies to ensure that fund managers are more effective in participating in the nomination committee experiments**. This will help create a systematic involvement behind governance innovation.

For policy makers and standard setters

6. **The Financial Reporting Council (FRC) to promote the annual re-election of boards and chairmen as suggested in the recent review of the Combined Code, but link the annual re-election with the recommendation that boards engage major shareholders in the nomination process**. The benefit of this change of emphasis is that annual re-election is no longer seen as a shortening of time horizon, but is seen as a way of making director evaluation and re-election part of a systematic process of review and continuous improvement.

"I greatly enjoyed reading this excellent report on the potential relevance of Swedish experience.

While I believe that the recommendations in my own report point us in the right direction, there is much more to be done in the UK on shareholder engagement and stewardship and this work on the Swedish model is a very interesting example for further exploration."

Sir David Walker, Chairman, Review of Corporate Governance of UK banks and other financial institutions

"This report does an excellent job of describing how the Swedish approach works and how it might be introduced in the UK. I believe it will provoke a productive debate on how shareholder stewardship can make a real difference to corporate governance."

Paul Strebel, Sandoz Family Foundation Professor and Director High Performance Boards Program IMD

"I was intrigued to read this study of the Swedish system, and its implications for our own drive to improve stewardship by investors in the UK. There are many questions about the practicalities but they need serious thought and this report will stimulate just the practical discussion that we now need."

Lindsay Tomlinson, Chairman, NAPF

Publications

Tomorrow's Company has published numerous influential reports that have informed and continue to help shape the actions of companies and governments in the UK and beyond.

Running a Successful Business in the Low-carbon Economy: A practical guide (2010)

Tomorrow's Global Talent: A new talent agenda for the UK (2010)

Tomorrow's Owners: Defining, differentiating and rewarding stewardship (2009)

Tomorrow's Innovation, Risk and Governance (2009)

Tomorrow's Climate: Beyond Peak Carbon. A discussion paper from Tomorrow's Company (2009)

Tomorrow's Global Talent: How will leading global companies create value through people? (2009)

Tomorrow's Owners: Stewardship of tomorrow's company (2008)

Tomorrow's Global Company: Challenges and Choices (2007)

The Purpose of Profit: Tomorrow's Company Lecture by Jeff Swartz (2005)

Restoring Trust: Investment in the twenty-first century (2004)

Redefining CSR (2003)

Lessons from Enron (2002)

Employee Ownership in Tomorrow's Company (2001)

Leadership in Tomorrow's Company (1999)

Sooner, Sharper, Simpler: a guide to the inclusive annual report (1998, reprinted 2006)

RSA Inquiry Tomorrow's Company: the role of business in a changing world (1995)

Joint publications with The Institute of Chartered Accountants in England and Wales:

Qualitative Growth, by Fritjof Capra and Hazel Henderson (2009)

Beyond Accounting, by Graham Hubbard (2009)

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